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Report to the Chairman, Subcommittee  
on Foreign Operations, Export Financing  
and Related Programs, Committee on  
Appropriations, House of  
Representatives

## MILITARY SALES TO ISRAEL AND EGYPT\*

### DOD Needs Stronger Controls Over U.S.-Financed Procurements.

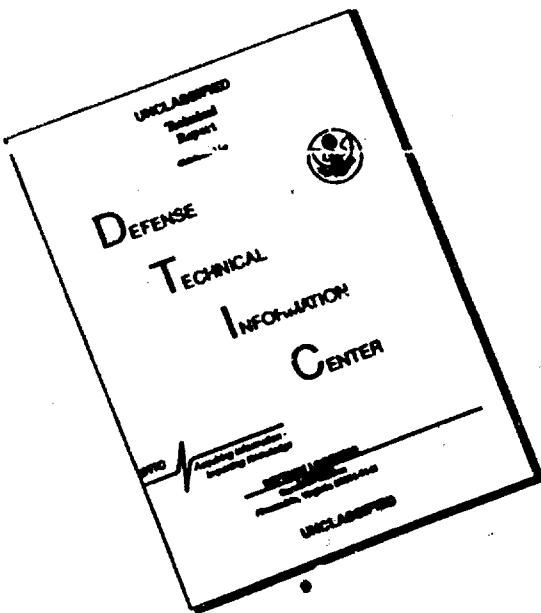


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# GAO

United States  
General Accounting Office  
Washington, D.C. 20548

National Security and  
International Affairs Division

B-253149

July 7, 1993

The Honorable David R. Obey  
Chairman, Subcommittee on Foreign Operations,  
Export Financing and Related Programs  
Committee on Appropriations  
House of Representatives

Dear Mr. Chairman:

In response to your request, we reviewed the Foreign Military Financing programs for Israel and Egypt. Effective January 1, 1994, the Department of Defense will discontinue U.S. financing of direct commercial sales under this program.

We wish to acknowledge the high level of cooperation received from the governments of Israel and Egypt during the course of our review.

Unless you announce the contents of this report earlier, we plan no further distribution of it until 30 days from its issue date. At that time, we will send copies to the Secretaries of Defense and State and other appropriate congressional committees. We will also provide copies to others upon request.

The report was prepared under the direction of Joseph E. Kelley, Director-in-Charge, International Affairs Issues, who may be reached on (202) 512-4128 if you or your staff have any questions. Other major contributors to the report are listed in appendix I.

Sincerely yours,



Frank C. Conahan  
Assistant Comptroller General

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# Executive Summary

## Purpose

The United States has granted billions of dollars in security assistance to Israel and Egypt through the Foreign Military Financing program. In 1991, Israel convicted one of its Air Force officers, General Rami Dotan, of skimming an estimated \$40 million in U.S. funds by submitting false purchase orders on U.S.-financed contracts. This incident, known as the "Dotan affair," raised congressional concerns about the possibility of additional fraud, waste, and abuse in the Foreign Military Financing program.

The Chairman, Subcommittee on Foreign Operations, Export Financing and Related Programs, House Committee on Appropriations, requested that GAO review the Foreign Military Financing programs for Israel and Egypt. GAO's objectives were to (1) determine why Israel and Egypt often purchase U.S.-funded goods and services directly from contractors rather than through the U.S. government and (2) identify any weaknesses in the program. GAO also examined the procurement procedures of each country (see chs. 4 and 5). Given time constraints and language barriers, GAO's review of these countries' procedures should not be construed as a certification of the adequacy of their internal controls.

## Background

Foreign Military Financing is largely a grant aid military assistance program that enables U.S. allies to improve their defense capabilities through the acquisition of U.S. military goods and services. The Department of Defense's (DOD) Defense Security Assistance Agency is responsible for managing the Foreign Military Financing program by approving contracts and payments. Israel and Egypt are the largest program recipients, with annual grants of \$1.8 billion and \$1.3 billion, respectively.

Most countries receiving Foreign Military Financing generally purchase goods and services through government-to-government contracts, also known as Foreign Military Sales. Under this procurement channel, the U.S. government buys the desired item on behalf of the foreign country, generally employing the same criteria as if the item were being procured for the U.S. military. Selected countries, including Israel and Egypt, could also apply their Foreign Military Financing funds to direct commercial contracts. Under direct commercial contracts, the foreign government selects the source and manages the contract. The U.S. government is not a party to such contracts.

## Results in Brief

In 1992, Israel allocated about \$1.1 billion,<sup>1</sup> or 60 percent, of its Foreign Military Financing to commercial procurement, and Egypt allocated about \$260 million, or 20 percent. GAO found that countries have legitimate reasons for choosing the commercial procurement channel. Many of the items bought commercially were not readily available through the U.S. government. However, for items routinely stocked by DOD, the Foreign Military Sales channel offers many advantages over commercial contracting in terms of price and availability. About two-thirds of the items in GAO's sample of commercial purchases that were also available through the U.S. government could have been purchased cheaper through the Foreign Military Sales channel.

Israel and Egypt have a variety of procedural safeguards designed to protect the integrity of purchases made through the Foreign Military Financing program. However, the Dotan affair, as well as subsequent DOD audits and investigations, revealed weaknesses in the commercial channel that made the program vulnerable to abuse. GAO identified a number of factors contributing to these weaknesses. Some of these factors also apply to the Foreign Military Sales procurement channel, although DOD controls over this channel are generally stronger. In June 1993, DOD announced the termination of commercial sales under the Foreign Military Financing program, effective January 1994, due to program weaknesses. This action will not eliminate the weaknesses found in the Foreign Military Sales channel.

## Principal Findings

### Both Countries Have Good Reasons to Purchase Items Through Commercial Contracts

Israeli and Egyptian officials indicated that for most purchases they request price and availability data first from DOD. If an item is available through both the Foreign Military Sales and commercial channels, the buyer usually selects the channel offering the best combination of price, availability, and quality. Contract flexibility and financial concessions may also influence the procurement method chosen.

For items routinely stocked by DOD, the Foreign Military Sales channel may be advantageous to the buyer, but not all items are readily available. In a random sample of 850 items procured by Egypt and Israel through the commercial channel, GAO could match only 154 items with an active DOD

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<sup>1</sup>Israel's figures include \$475 million in Foreign Military Financing allocated to commercial procurement in Israel.

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national stock number. About one-third of the available items were purchased cheaper commercially. Two-thirds of these items (103) could have been purchased through the Foreign Military Sales channel at a savings of more than 50 percent, but delivery time might have been a factor in some cases because only 65 of the items were in DOD stocks. The remainder would have required ordering. While Foreign Military Sales are generally limited to standard U.S. items, the Defense Logistics Agency and the military services have recently initiated new procedures, using contractors, which allow them to procure nonstandard items for other countries.

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**Dotan Affair and Subsequent DOD Audits Revealed Program Weaknesses**

The disclosure that Dotan and a senior official of General Electric Company had defrauded the U.S. government of \$40 million in a commercial contract financed by the Foreign Military Financing program revealed the vulnerability of the commercial channel to collusion between contractors and foreign officials. According to information available to us, Dotan defrauded the Israeli government, and in turn the U.S. government, by working out various schemes with General Electric to create pools of funds for personal use and for unauthorized projects.

Since the Dotan affair, DOD audits have found that U.S.-financed commercial contracts are vulnerable to abuses by contractors. In a number of contracts awarded by Egypt and Israel, auditors uncovered evidence that contractors may have improperly used Foreign Military Financing funds to (1) pay questionable commissions, (2) reimburse foreign officials for travel expenses, or (3) make payments for items that were not of U.S. origin.

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**Factors Contributing to Weaknesses in the Foreign Military Financing Program**

A number of factors contribute to the weaknesses identified in the Foreign Military Financing program. Some of these factors are unique to the commercial channel. In particular, when foreign countries use this channel, they lack access to contractor records, increasing the risk that unallowable expenses will be charged to the contract. Moreover, contractors often maintain poor records, making it difficult for U.S. government auditors to confirm any wrongdoing by the contractor. In addition, the countries' procurement authority may not monitor contractor performance nor exercise the option of using DOD to provide this service. Other factors apply to the Foreign Military Sales channel as well as the commercial channel. Specifically, concerns over subcontractors,

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commissions, sole-sourcing, and offset agreements exist regardless of which procurement channel the foreign country uses.

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**Stronger DOD Controls Could Reduce Vulnerabilities in the Program**

DOD could reduce, but probably not eliminate, the vulnerabilities in the program by instituting stronger program controls. For instance, foreign countries may contract with DOD's Defense Contract Management Command to obtain services such as pre-award capability surveys of subcontractors, contract price analysis, and quality assurance support. These services, if applied to commercial contracts funded under the Foreign Military Financing program, could provide greater assurance that purchased goods and services are delivered and that contractors are complying with DOD program requirements. Currently, DOD does not require foreign countries to purchase these services for commercial contracts, and neither Israel nor Egypt routinely use these services.

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**Recommendations**

To reduce the vulnerability of the Foreign Military Financing program, GAO makes a number of recommendations designed to strengthen DOD's controls over the program in chapter 3.

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**Agency Comments**

As requested, GAO did not obtain written agency comments on its report. However, GAO discussed its findings with DOD program officials and representatives of the governments of Israel and Egypt, and has included their comments where appropriate. The DOD program officials generally agreed with the report's findings and conclusions. DOD's decision to terminate the program's commercial channel effective January 1994 may appear to make GAO's recommendations moot. However, GAO believes that these recommendations are valid as long as any portion of the commercial channel remains active. Furthermore, some of the program weaknesses discussed in this report also pertain to the Foreign Military Sales channel.

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**Abbreviations**

DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DOD	Department of Defense
DSAA	Defense Security Assistance Agency
FMF	Foreign Military Financing
FMS	Foreign Military Sales
GAO	General Accounting Office
IDF	Israeli Defense Forces
LOA	Letter of Offer and Acceptance
MOD	Ministry of Defense
SAO	Security Assistance Organization

# Introduction

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The Foreign Military Financing (FMF) program is largely a grant aid program that enables foreign countries to acquire U.S. military goods and services. The program is authorized by the Arms Export Control Act of 1976, as amended.<sup>1</sup> Department of Defense (DOD) Manual 5105.38-M, "Security Assistance Management Manual," provides specific guidance on implementing policies and procedures.

As a security assistance program, FMF serves a broad range of U.S. interests. FMF increases the ability of U.S. friends and allies to defend themselves and secures U.S. access to important military facilities throughout the world. FMF also benefits the U.S. domestic economy because FMF acquisitions are generally restricted to U.S. companies. Foreign sales can also result in economies of scale (for example, longer production runs), which reduce the cost of weapon systems for the U.S. military.

The Department of State is responsible for determining the general direction of the FMF program, including the size and scope of funding for individual countries. DOD is responsible for implementing the program, primarily through the Defense Security Assistance Agency (DSAA).

DSAA administers and supervises FMF planning and programs, oversees FMF-funded sales to countries, serves as the DOD focal point with U.S. industry, manages FMF credits and grants, and develops FMF guidance. DSAA is also responsible for approving requests for the financing of individual contracts.

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## Foreign Military Financing to Israel and Egypt

Since the Camp David Accords in 1979, the United States has provided billions of dollars in security assistance to Israel and Egypt. These funds were provided to encourage a comprehensive settlement of the Arab-Israeli conflict and to promote stability and security in the Middle East. Through the mid-1980s, security assistance to Israel and Egypt included loans, some at high interest rates which contributed to economic problems in these countries. Since fiscal year 1985, Israel and Egypt have not been required to repay their military assistance loans. Moreover, since fiscal year 1989, Israel and Egypt have received all their military assistance in the form of grants. FMF grants to Israel and Egypt together constituted about 67 percent of the total FMF budget for fiscal year 1992.

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<sup>1</sup>See 22 U.S.C. 2761 et seq.

Since 1987, Israel has received \$1.8 billion annually in FMF aid and is the largest recipient of FMF. Israel's Ministry of Defense (MOD) is the procurement authority responsible for buying the military equipment requisitioned by the Israeli Defense Forces (IDF). MOD established a purchasing mission in New York, staffed by more than 200 personnel, to handle the purchase of defense goods and services in the United States. MOD also has representatives at defense plants and U.S. military installations to manage particular projects. The purchasing mission is responsible for soliciting bids, negotiating and awarding contracts, paying contractors, and requesting reimbursement from the U.S. government. In addition, the mission employs a freight forwarder that obtains export licenses from the Departments of State and Commerce and handles almost all shipments to Israel.

Egypt has received \$1.3 billion annually in FMF funds since 1987 and is the second largest recipient of FMF. In Egypt, the Ministry of Defense's Armament Authority manages the FMF program, including the solicitation of bids and the negotiation and awarding of contracts to U.S. firms. Egypt maintains a small procurement office in Washington, D.C., that is responsible for monitoring its U.S. contracts. Egypt also employs a freight forwarder that obtains export licenses and handles all shipments.

## Foreign Military Sales and Commercial Sales

Israel and Egypt can use their FMF funds to purchase U.S. defense goods and services in two ways—Foreign Military Sales (FMS) or direct commercial contracts. FMS, also known as government-to-government or military sales, involves a formal agreement between the U.S. government and the foreign government whereby DOD acts as the contracting agent. When procuring items for a foreign government, DOD generally applies the same contract clauses and contract administration as it would use in procuring the items for itself.

Commercial contracts can be used for FMF purchases by Israel and Egypt (and some other countries).<sup>2</sup> A commercial contract is a sale between a U.S. contractor and a foreign country without direct U.S. government involvement in the contract, though the United States is involved in the financing through FMF. Unlike FMS, commercial contracts are not administered by DOD and do not involve any government-to-government agreement. Because the U.S. government is not a party to commercial

<sup>2</sup>The other countries permitted to use their FMF grants or loans to make commercial purchases are Greece, Turkey, Portugal, Morocco, Tunisia, Jordan, Pakistan, and Yemen.

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contracts, the procurement is not subject to the full breadth of the Federal Acquisition Regulation or other DOD procurement rules.

DSAA has issued a series of guidelines and procedures to control commercial contracting. These guidelines were first developed in 1984, then revised in 1985, 1987, 1989, and again in 1991. The guidelines impose a variety of requirements upon FMF recipients that buy commercially. Contractor compliance with the guidelines and the contractor certification requirement are monitored by DSAA, the Defense Criminal Investigative Service, and the Defense Contract Audit Agency (DCAA). Among other things, the contractor certification ensures that the contractor is aware of costs ineligible for FMF funds and provides for contract audit by the U.S. government. Contract administration and contractor compliance with the contract are the country's responsibility.

DSAA's Operations Directorate reviews the commercial contracts for compliance with the agency's guidelines. The DSAA country desk officer reviews the request for conformance with the country's acquisition plan. For Egypt, the review process includes notification to the Security Assistance Organization (SAO)<sup>3</sup> in-country for its comment. After this review, the DSAA Comptroller commits the funds and sends an approval letter to the country and the contractor. For Israel, coordination takes place between its purchasing mission in New York and U.S. officials in Washington.

There are four important differences between Israel and Egypt in the rules and review process for commercial contracts. The rules differ for Israel, in part, because of the sheer volume of its commercial transactions—the purchasing mission processes about 20,000 purchase orders annually.

- First, Egypt (and most countries) must obtain DSAA approval before the contract is executed regardless of the contract value. For Israel, only contracts valued at over \$1 million require prior approval. Israeli contracts between \$50,000 and \$1 million are submitted to DSAA for approval after-the-fact on a monthly basis. Contracts below \$50,000 are not submitted to DSAA, but are retained at the mission.
- Second, for Egypt (and most countries) the total value of a commercial contract must exceed \$100,000 to be eligible for FMF. Israel can purchase commercially in any amount.

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<sup>3</sup>Security Assistance Organizations, located at U.S. embassies overseas, coordinate FMF efforts in-country. These offices operate under the direction and supervision of the Ambassador.

- Third, Egypt (and most countries) must submit signed contractor certifications along with all contracts. Israel needs to submit contractor certifications only for contracts over \$500,000. For lower priced contracts, Israel obtains (but does not submit) modified versions of the contractor certification.
- Finally, for Egypt (and most countries) the contractors submit invoices to DSAA through the countries' defense attaches for payment. For Israel, contractors submit invoices to MOD's purchasing mission in New York. Israel pays these with its own funds and then seeks reimbursement from DOD, which releases FMF funds from Israel's interest-bearing account at the Federal Reserve Bank. Then, on a semiannual basis, DOD's Security Assistance Accounting Center reviews a select number of the disbursements by examining the associated invoices retained at the purchasing mission.

Israel predominantly uses commercial contracts, although its use of FMS has increased in recent years in reaction to corruption uncovered in commercial contracting. For example, in fiscal year 1989, Israel used about 84 percent of its FMF, or about \$1.5 billion, to purchase defense items directly from commercial vendors. In fiscal year 1992, Israel allocated 60 percent of its FMF, or about \$1.1 billion, to purchase items directly from commercial vendors. Although the majority of the annual FMF allocation is spent in the United States, since 1984 Israel has been authorized to spend an increasing amount of its funds in Israel reimbursing Israeli contractors for offshore procurements. Of the \$1.1 billion allocated to commercial procurement in 1992, \$475 million was spent on offshore commercial procurement in Israel.<sup>4</sup> Since 1979, Egypt has allocated 20 percent of its FMF to direct commercial sales.

## Corruption Cases Raise Concerns About Commercial Contracts

Commercial contracts financed by FMF have a history of impropriety, including fraudulent pricing schemes involving kickbacks and unreasonably high prices. In addition, concerns about commercial contracts have been heightened by two recent internal corruption cases, one involving Israel and the other involving Egypt.

In 1991, Israel convicted one of its top officials, Air Force General Rami Dotan, of skimming \$40 million in FMF funds by submitting false purchase orders on an F110 aircraft engine logistical support contract with General Electric Company. The contract required that General Electric be

<sup>4</sup>Our report, *Israel: U.S. Military Aid Spent In-Country* (GAO/NSIAD-91-169, May 23, 1991), discusses lack of oversight over U.S.-financed procurement in Israel.

responsible for the construction, modification, and adaptation of testing and other support facilities. According to the civil action complaint against General Electric,<sup>5</sup> Dotan worked in collusion with Herbert Steindler, an international sales manager with General Electric, to subcontract some of this work to Ingbir Engineering, an Israeli firm in which Dotan held an interest. Dotan was imprisoned for his part in the scandal, which became known as the "Dotan affair." In July 1992, General Electric accepted responsibility for the improper action of its employees and agreed to a settlement with the Department of Justice, which involved payments of \$59 million in civil damages and penalties and \$9.5 million in criminal penalties. Steindler's employment with General Electric was terminated, and 11 other employees were discharged for either knowingly violating or failing to comply with General Electric's policies.

Also in 1991, the Justice Department, working with the Defense Criminal Investigative Service, secured a conviction regarding a commercial contract between Egypt and Detroit Armor Corporation. According to Investigative Service documents, the former president of the firm was convicted of making two false statements to DSAA regarding the payment of \$93,262 in illegal commissions on a commercial contract for an indoor firing range for Egypt. This individual had certified to DSAA that no commissions had been paid. The president had also falsely certified that the company had not employed foreign services, when, in fact, it had hired a British firm to perform some of the work.

The Justice Department, DOD's Defense Criminal Investigative Service, and GAO's Office of Special Investigations have ongoing investigations involving FMF commercial contracts.

## DSAA Recently Eliminated the Commercial Channel Due to Program Weaknesses

In a letter dated June 8, 1993, DSAA informed contractors and FMF recipients of its decision to terminate use of FMF for direct commercial procurement effective January 1, 1994. DSAA's decision to terminate the commercial side of the program was based on the program weaknesses revealed initially by DOD's Office of the Inspector General and confirmed by the DCAA.<sup>6</sup> DSAA's

<sup>5</sup>The action to recover damages from General Electric is detailed in the second amended complaint filed in the U.S. District Court, Southern District of Ohio. United States v. General Electric Company, civil action no. C-1-90-792 (S.D. Ohio, Mar. 16, 1992).

<sup>6</sup>In a May 1991 report, Commercial Sales Financed Under the Foreign Military Sales Financing Program, the DOD Inspector General found that DSAA had ineffective internal controls over the review, processing, and monitoring of direct commercial contracts. Specifically, DSAA had not required countries to submit acquisition plans and letters on contractor selection, and DSAA was not conducting price comparisons.

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termination of the program includes a transition period for contracts already under negotiation and amendments to existing contracts.

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## Objectives, Scope, and Methodology

The Chairman, Subcommittee on Foreign Operations, Export Financing and Related Programs, House Committee on Appropriations, requested that we review policies and procedures related to the FMF programs for Israel and Egypt. Our specific objectives were to (1) determine why Israel and Egypt often purchase FMF-funded goods and services directly from contractors rather than through the U.S. government and (2) identify any weaknesses in the program. We also examined the procurement procedures of each country.

We performed our work at various U.S., Israeli, and Egyptian agencies. We interviewed officials, reviewed implementing guidance, and analyzed supporting documents provided by officials at DSAA's Operations Directorate, the Army's Security Assistance Command, the Air Force's International Affairs Office, the Navy's International Programs Office, and U.S. embassies in Tel Aviv and Cairo. For Israel, we met with officials and reviewed documents at MOD's purchasing mission in New York. In Tel Aviv, we met with officials of MOD's Directorate of Procurement and Production, the Ministry of Finance, IDF, and the State Comptroller's Office. For Egypt, we met with officials and reviewed files at the procurement office in Washington and the Armament Authority and military services in Cairo. We also contacted the Egyptian Central Auditing Organization.

Our work focused primarily on the policies and procedures related to FMF-financed commercial contracts because DSAA relies on the countries to manage the contract and, thus, there is little U.S. government oversight. While we also reviewed FMS contracts, we did not conduct in-depth work in this area because the U.S. military services manage these contracts like any other DOD contract. DOD contract management has U.S. government oversight through the Defense Logistics Agency, the DOD Inspector General, the DCAA, and our office.

To determine Israel's and Egypt's reasons for selecting commercial contracts, we asked officials of these countries why they selected the commercial channel for specific contracts, then reviewed supporting documentation. We also selected a sample of items purchased commercially by Israel and Egypt to determine whether the items could have been purchased through FMS and then compared prices and delivery times between the FMS and commercial channels. In addition, we

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interviewed and obtained documents from DSAA and U.S. military service officials to assess problems and potential improvements in the FMS process.

To review Israel's and Egypt's procedures for the FMF program, we asked officials of these countries to describe and document their procurement process. From their detailed presentations, we selected key procedures and tested them by reviewing contract files. For example, in a case where the country had reported to DSAA that a contract was awarded through competitive selection, we looked for documentation of a solicitation and multiple offers. In both countries, we spot-checked deliveries on some items from recent FMF contracts by physically verifying their arrival at military warehouses.

Our review was designed to identify the two countries' procurement procedures and their compliance with those procedures; it should not be construed as a certification of the adequacy of these countries' internal controls given the limitations on our work. First, we spent only 2 to 3 weeks in Israel and Egypt. Thus we had only a short time to meet with key individuals and review important documents. This also limited the number of contracts that we could review. Second, the files we reviewed were a combination of English and Hebrew or Arabic. To some extent, we relied on Israeli and Egyptian officials for spot translations of specific documents. Third, to coordinate our work with Egyptian and Israeli officials, we had to provide them with advance notice about our planned activities (such as inventory checks), so our work did not entail a surprise audit. Finally, these countries had complicated organizational structures and operating procedures for managing FMF purchases.

We also analyzed recent FMF fraud schemes to identify vulnerable areas. In addition, we met with officials and/or reviewed reports from DSAA, the DOD Inspector General, the Defense Criminal Investigative Service, the DCAA, and the Defense Contract Management Command (DCMC). We did not investigate individual contracts, nor did we use any information from ongoing criminal investigations by other U.S. government agencies.

We conducted our review from May 1992 to June 1993 in accordance with generally accepted government auditing standards. As requested, we did not obtain written agency comments on the report. However, we discussed our findings with DOD program officials and representatives of the governments of Israel and Egypt and have included their comments where appropriate. DOD program officials generally agreed with our findings and

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conclusions. Although our scope was limited to Israel and Egypt, DSAA officials also stated that our findings (except for country-specific procedures) were common to the FMF program as a whole.<sup>7</sup>

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<sup>7</sup>At the request of the Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, we are conducting a separate review of FMF programs for Greece and Turkey. We plan to report our findings in late 1983.

# Egypt and Israel Have Legitimate Reasons for Choosing Commercial Over FMS Purchases

No single consideration dictates Egypt's or Israel's selection of either the FMS or commercial channel. From their perspective, the price, availability, and quality of the item or service are generally the most important considerations in choosing between the two approaches. Other considerations include contract flexibility and financial concessions. For items routinely procured by DOD, FMS purchases frequently offer the customer price, quality, and delivery advantages. But if the item is not in the DOD inventory, the FMS channel is often less responsive to the buyer than the commercial channel. These observations are not unique to Egypt and Israel; rather, they are representative of the program as a whole.

## Countries Initially Consider FMS

According to Israeli and Egyptian officials, they initially look to the FMS channel to fulfill their defense requirements. They routinely request FMS price and availability data when shopping for defense items. Both countries have acquired computer data bases that provide them with information on defense items procured by the U.S. military, such as information on manufacturers, the prices DOD paid, and the dates of purchase. Although Israel has a stated preference for FMS, it has used the commercial channel extensively. However, as stated previously, Israel's FMS purchases have risen significantly in recent years, from 16 percent in fiscal year 1989 to 40 percent in fiscal year 1992.

Until DSAA recently terminated the commercial channel, it did not have a stated preference as to whether a country used the FMS or commercial channel. However, to generate greater use of the FMS channel, DSAA had instituted a requirement in August 1992 that countries, except for Israel, try to obtain spare parts through FMS prior to buying parts commercially.

## FMS Usually Offers Price Advantage

Our analysis indicated that FMS prices are generally, but not always, lower than commercial prices. Of 154 randomly selected items that the 2 countries purchased commercially between October 1, 1991, and June 30, 1992, 103 (Egypt—68, Israel—35) would have been less expensive if they had been purchased through FMS. However, only 65 items were available from DOD stocks, and the remainder would have had to be ordered. If Israel and Egypt had purchased these 65 items through the FMS channel, they would have saved over \$330,000. However, DOD item managers told us that just because items were in stock does not guarantee that they would release them to FMS customers. Item managers may want

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**Egypt and Israel Have Legitimate Reasons**  
**for Choosing Commercial Over FMS**  
**Purchases**

to hold reserves for expected future DOD requirements and place the FMS request on a future order. Table 2.1 shows how much more the two countries paid for these 65 requisitions by buying commercially.

**Table 2.1: Items That Had Lower DOD Prices and Were Available From DOD Stocks**

Country	No. of Items	Total commercial price	Total DOD price	Amount commercial price above DOD price	Overage as a percent of total commercial price
Egypt	42	\$269,356	\$126,240	\$143,116	53
Israel	23	297,573	106,725	190,848	64
<b>Total</b>	<b>65</b>	<b>\$566,929</b>	<b>\$232,965</b>	<b>\$333,964</b>	<b>59</b>

The largest price difference was Israel's commercial purchase of nine aircraft engine liners that cost \$12,860 each. The liners were available through FMS for \$3,832. Thus, Israel paid a total additional cost of about \$81,000. In another example, Egypt paid over \$3,300 apiece more commercially for computer circuit card assemblies than it would have through FMS. The unit commercial price was \$5,253, while the DOD unit price was \$1,912.

For the remaining one-third of the items in our sample, the commercial price was less than the FMS price, and the differences were also significant. Table 2.2 shows how much more the two countries would have paid if they had bought the 51 items through FMS instead of commercially.

**Table 2.2: Items That Had Lower Commercial Prices**

Country	No. of Items	Total DOD price	Total commercial price	Amount DOD price above commercial price	Overage as a percent of total commercial price
Egypt	28	\$181,246	\$121,036	\$60,210	50
Israel	23	520,847	329,044	191,803	58
<b>Total</b>	<b>51</b>	<b>\$702,093</b>	<b>\$450,080</b>	<b>\$252,013</b>	<b>56</b>

The largest difference was more than \$112,000 for an order of 200 tent liners bought by Israel. Israel would have paid 375 percent more for these items through FMS. Egypt purchased circuit card assemblies with a commercial unit price that was more than \$2,000 less than the DOD price. Egypt would have paid an additional \$31,672 for 15 assemblies if it had used the FMS channel.

Although DSAA is required to perform price comparisons on a selective basis as part of the contract review process, such comparisons are rarely, if ever, done. DOD buying organizations responsible for managing U.S. procurements are capable of performing such price comparisons, but DSAA rarely requests that they do so, even on high-value commercial contracts.

## **FMS Prices Are Estimates Subject to Change**

Israeli and Egyptian officials said one of the problems with the FMS channel is that the prices quoted are often estimates subject to change. According to DOD officials, FMS prices are estimates for a number of reasons. First, the basis for FMS pricing is the Arms Export Control Act, as amended, which generally requires that the U.S. government recover all costs relating to FMS. The customer is charged the base price of the item (or replacement value if the item is taken from DOD stock), management expenses, and a share of the overhead and other costs incurred by the U.S. government, with profits controlled by the Federal Acquisition Regulation.

Second, for the FMS purchase of a major system, the customer typically signs a Letter of Offer and Acceptance (LOA) with DOD, which may include upwards of 40 individual line items. Prices for some of these items remain undefined until well into contract implementation and product delivery on a long lead-time purchase. Often, however, FMS and DOD orders are consolidated to obtain economies of scale and, therefore, lower unit prices, which benefit both the foreign buyer and DOD.

Third, DOD contracts usually provide for cost reimbursement plus a negotiated fee. Modifications and subsequent amendments to the contract, may drive the price up. Further, on a purchase involving many foreign buyers, a change in requirements by one buyer may affect the price DOD and the other buyers will ultimately pay.

According to Israeli and Egyptian officials, one of the advantages to commercial contracting is that the customer can usually negotiate a fixed-price contract, which eliminates the risk of price increases.

## **FMS Pricing Creates Budget Uncertainty**

FMS prices on major systems are more difficult for countries to budget for because the prices are estimates until completion of the long LOA

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termination process.<sup>1</sup> According to DOD officials, the LOA estimate is typically 11 to 13 percent higher than the final price; however, the foreign buyer must budget the entire amount until it receives a final bill from the U.S. government, which may occur years after the items have been delivered.

Until recently, FMS purchases took an average of 5 to 10 years to finalize the price and terminate the LOA because long-running contracts could not be closed until the entire contract was fully delivered for all participants, the final audit was made by the DCAA, and the final overhead costs were determined. Consequently, countries were required to budget for these purchases at the higher cost estimates. Such delays in "case closure" were a disincentive to using the FMS channel.

In February 1992, the DOD Comptroller issued new procedures for timely FMS case closure. The procedures require that within 24 months after all goods and services are delivered, the responsible DOD component must estimate the remaining costs, charge the country's account, and issue an interim case closure certificate. When final costs are known, the account is settled and the case is closed. Countries should be better able to budget their FMF resources under these new procedures and may have more incentive to use the FMS channel.

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## **Items Not Always Available Under FMS**

Although many items Israel and Egypt purchased commercially could have been bought for less through FMS, item availability (the time it takes the country to receive the item) is also a major factor in any procurement decision. If an item is available from DOD stocks, delivery times for FMS purchases are considerably less than if the item must be ordered.

Of the 154 items in our sample, 38 had lower DOD prices but were not available for delivery at the time of the order. It would have taken more than a year in many cases to have these items delivered to the FMS customer. Table 2.3 shows how much more the two countries paid for these 38 items.

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<sup>1</sup>For Egypt, the lengthy contract process also ties up funds committed up front to cover its contract termination liability.

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**Table 2.3: Items That Had Lower DOD Prices but Were Unavailable From DOD Stocks**

Country	No. of Items	Total commercial price	Total DOD price	Amount commercial price above DOD price	Overage as a percent of total commercial price
Egypt	26	\$255,760	\$134,502	\$121,258	47
Israel	12	146,582	106,780	39,802	27
<b>Total</b>	<b>38</b>	<b>\$402,342</b>	<b>\$241,282</b>	<b>\$161,060</b>	<b>40</b>

Twenty hand control units ordered by Egypt would have cost almost \$24,000 less under FMS, but delivery would have taken 26 months. According to the commercial contract, the delivery schedule was 4 to 18 months. The total commercial price was \$40,860, while the DOD price would have been \$16,995. Israel could have saved \$734 apiece, or 28 percent, on four electronic components if it had been willing to wait 2 years for delivery under FMS. According to Israeli files, delivery on the commercial purchase took about 9 months.

**Sometimes Buying Commercial Is Only Option**

Sometimes the commercial channel is the only option available to a foreign buyer. Moreover, if the buyer believes its defense equipment does not need to be built to U.S. military specifications or be standardized with DOD equipment, DOD will probably encourage that the acquisition be made through the commercial channel. Items available through DOD are tracked by national stock number. If an item does not have such a number, the foreign customer may not be able to purchase it under the FMS system. For many of the commercial purchases we examined, it did not appear that the FMS channel was an option. Of a random sample of 850 Israeli and Egyptian commercial purchases, only 154 had active DOD national stock numbers and current pricing data upon which to readily make a comparison.

For some FMS requests, U.S. officials may also encourage a country to buy commercially if the customer's requirements differ from those of DOD. To illustrate, Israeli officials cited two cases in which it was directed by U.S. officials to the commercial procurement channel. In the first case, the U.S. Coast Guard recommended that Israel buy a particular test set directly from the manufacturer because the Coast Guard's purchase was almost complete, and because accommodating Israel's request would have required lengthy contract modifications. In the second case, the U.S. Navy did not process Israel's request to purchase a particular generator because the Navy did not anticipate contracting for generators for its own use at that time. Moreover, Israel's specifications for the unit were different from the Navy's.

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**DOD Has Established Nonstandard Acquisition System**

To make FMS more responsive to foreign buyers' requests for nonstandard items, DOD components have recently established new nonstandard procurement systems. The old system of requisitioning and distributing nonstandard items proved costly to the United States and increased the time and replacement cost for the customer. Under most of these new systems, the foreign buyer's requirement is turned over to a contractor that will research and obtain the item for the requesting service, which in turn will provide it to the foreign buyer. The contractor solicits bids from other contractors, awards the contract, receives and inspects the product, then packs and ships it to the FMS customer's freight forwarder. The Army's system is different in that its Tank and Automotive Command basically performs the same functions as the contractor under the other services' systems.

Thus far, the nonstandard procurement systems have had mixed reviews. Egypt purchased more than \$230,000 in nonstandard parts from the Army under 135 requisitions from October 1, 1991, through June 30, 1992, and submitted another 176 requisitions to be filled. Israeli officials commented that delivery of nonstandard items may be timely, but prices are high and quality is uncertain. They believe the contractor has no incentive to negotiate the price downward. Further, they said no quality assurance is performed on the items shipped. Israel had only three pending requisitions in the Army system from October 1, 1991, through June 30, 1992. DSAA officials believe that prices may be high because of the low volume of orders submitted to the contractors. They said that as more orders are placed, the prices should come down.

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**Countries Have Different Views on Product Quality**

Another important consideration in buying is the quality of the product. On an FMS purchase, quality control is performed by U.S. government personnel to ensure that the items meet military specifications. Article testing, acceptance, and inspection are provided by personnel located, in many cases, at the contractor's or subcontractor's facilities. These DOD services are not part of a commercial contract but may be purchased from the DCMC under an FMS agreement if the customer desires. According to the director of the Egyptian Armament Authority, Egypt recognizes the advantages of quality inspections by the DCMC under the FMS system. In fact, he told us that Egypt planned to increase its use of DCMC services on commercial contracts. Israel prefers, whenever possible, to place its own personnel at the various contractor facilities to perform such services. In August 1992, Israel reported that it had 39 resident project officers located at contractor facilities throughout the United States.

Israel also believes that certain items or services must be procured from the original manufacturer in order to obtain a quality product and to guarantee their compatibility with existing systems. For instance, Israel has a list of 6,000 items it will buy only from the original manufacturer. These so-called "safety" items were defined as part of an assembly or subassembly whose failure or malfunction could contribute to the loss or severe damage of a weapon system or loss of personnel.

The Israelis showed us several safety items procured through the FMS channel that had obvious quality defects, and they provided us with a list of defective parts purchased under FMS, one of which they said caused a helicopter to crash. They believe purchasing these items commercially from the manufacturer or its authorized distributors reduces the risk of quality problems. The Israelis told us they would purchase safety items through the FMS channel only if the U.S. government bought the items from sources approved by the Israeli Air Force. Thus, in some cases, the justification for limiting vendor selection may be the same justification for choosing the commercial channel over FMS. The Israelis, however, also showed us safety items purchased commercially that had obvious quality defects. They acknowledged that quality problems existed in both the FMS and commercial channels.

Prior to the Dotan affair, the Israeli Air Force defined about 30,000 items as safety items. Dotan was able to designate safety items, which allowed those purchases to be directed to specific manufacturers that overcharged Israel and were reimbursed by the U.S. government. Since the Dotan affair, Israel has revised its list of safety items, dropping approximately 24,000 items from the list. According to the Israelis, about 4,000 of the current 6,000 safety items have DOD national stock numbers and are therefore potentially available through the FMS channel. For most items Israel could provide no analytical data to support its contention that the original manufacturer is better than any other, or that the supplier used by the U.S. military is inferior. We suggested to Israeli officials that vendors that provide inferior products should be identified to the U.S. military to prevent the purchase of inferior products for U.S. government stocks.

An FMS procedure permitting a foreign buyer to designate a single vendor when procuring spare parts would appear to address Israel's need to buy from the original source. If the buyer denotes Single Vendor Integrity when it submits an LOA request, it means the item must be procured not only from a particular prime contractor, but also from the same subcontractors or suppliers used in the initial purchase. A disadvantage to

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this procedure is that if the DOD implementing agency incurs additional costs in managing the purchase, the costs will be taken out of the country's FMF funding.

# DOD Lacks Adequate Controls in the FMF Program

The Dotan affair and subsequent audits have revealed weaknesses in the FMF program. Dotan, in collusion with General Electric, was able to exploit these weaknesses in various schemes to defraud the Israeli and U.S. governments. All of these schemes involved commercial contracts; however, some of the schemes might have succeeded even if FMS contracts had been used. DOD audits of other commercial contracts awarded by Egypt and Israel found evidence that contractors did not always comply with DSAA requirements concerning the payment of commissions, the reimbursement of travel expenses, and the origin of purchased items. We found that DOD does not have adequate controls to ensure that contractors comply with DSAA certification requirements. As a result of program weaknesses identified by DOD audits and investigations, DSAA has recently terminated the commercial channel of the FMF program.

## Dotan Exploited Program Weaknesses to Divert Funds for Unauthorized Uses

The disclosure that Dotan and a senior official of General Electric had defrauded the U.S. government of \$40 million in an FMF-financed commercial contract revealed the vulnerability of the commercial contracting process to collusion between contractors and foreign officials. According to information available to us, Dotan worked out various schemes with General Electric to create pools of funds for personal use and for unauthorized projects. These schemes involved the following:

- Falsified documents were submitted to MOD certifying that goods and services were delivered or milestones were completed when they were not.
- Overpriced and unauthorized items were supplied to the Israeli Air Force.
- The prime contractor used a U.S subcontractor to transfer funds to European banks and to subcontract with an Israeli firm to perform unauthorized work.

Our analysis of the Justice Department complaint filed against General Electric and our review of U.S. and Israeli procurement procedures showed that Dotan took advantage of (1) exceptions in U.S. and Israeli procurement procedures that permit sole-source contracting and (2) limited internal controls on the delivery of goods and services.

## DOD Audits Found Evidence That Contractors May Have Violated Certain Program Requirements

Since the Dotan affair, DOD audits have found that FMF-financed commercial contracts are vulnerable to abuses by contractors. In a number of contracts awarded by Egypt and Israel, auditors uncovered evidence that contractors may have improperly used FMF funds to (1) pay questionable commissions, (2) reimburse foreign officials for travel expenses, or (3) make payments for items that were not of U.S. origin.

Audit Agency officials commented that these problems were not unique to Egypt and Israel. Similar problems have been found in FMF commercial contracts awarded by other countries, including Greece, Turkey, and Pakistan. DSAA is trying to recover about \$4 million as a result of these audits.

Since commercial contracts are not subject to the Federal Acquisition Regulation, the Audit Agency does not use normal Federal Acquisition Regulation criteria when conducting these audits. Instead, it audits for compliance with the contractor's certification to DSAA that certain financing eligibility requirements have been met. From April 1991 through January 1993, the Audit Agency completed audits of nine Egyptian and two Israeli contracts totaling \$846 million.<sup>1</sup> It currently plans to conduct additional audits of commercial contracts (15 involving Egypt and 22 involving Israel).

### Undeclared Commissions

DSAA prohibits contractors from using FMF funds to pay commissions or other contingent agent fees over \$50,000 for both FMS and commercial purchases. Further, DSAA requires contractors to identify any such expenses.<sup>2</sup> However, companies are permitted in FMS and commercial purchases to pay commissions in excess of \$50,000 if paid from company profits. In several audits, the DCAA uncovered evidence that FMF funds were used to pay commissions in cases where the contractor had certified otherwise.

- In a \$227 million Egyptian contract with Loral Aerospace International for missiles and related hardware, auditors found that Loral had paid more than \$1 million in commissions to UNITRA, an Egyptian firm staffed with

<sup>1</sup>Every foreign operations appropriations act since fiscal year 1989 has required audits of direct commercial contracts approved by DSAA.

<sup>2</sup>In addition to these DSAA restrictions, certain countries have procurement regulations prohibiting the payment from FMF of any direct or indirect costs of sales commissions or fees for contractor sales representatives unless the commissions and fees have been identified and approved in writing by the government prior to the contract award. The countries with such restrictions are Egypt, Greece, Israel, Jordan, Pakistan, and Turkey.

former Egyptian officers with contacts in the military.<sup>3</sup> Loral contends that the commissions were paid from corporate profits, not from any FMF or DOD contracts.

- In a \$33.5 million Israeli contract with Commodore Aviation to upgrade C-130 aircraft, auditors found that the contractor did not have sufficient internal controls to ensure that commission expenses were in compliance with DSAA requirements. Regarding indirect commissions, the contractor lacked adequate data on who received these commissions, what services were rendered, and how the commissions were calculated.
- In a \$69 million Egyptian contract with Beech Aircraft for surveillance aircraft, auditors found that a subcontractor, Motorola, paid a contingent fee of \$417,000 to an Egyptian sales agent, Technical Aerospace Consultants. When the auditors uncovered these expenses, Beech contacted Motorola, which claimed the contingency fee was actually a subcontract for support services.

As discussed in chapter 1, an investigation by the Defense Criminal Investigative Service into an Egyptian contract with Detroit Armor Corporation resulted in a conviction regarding the payment of commissions. The firm's former president was convicted on charges of making a false statement to DSAA regarding the commission payments.

A congressional committee is also probing alleged contractor fraud. One such case under review was filed by a former employee against Teledyne. The employee alleges that Teledyne paid illegal commissions and overcharged the U.S. and Egyptian governments on defense contracts.

#### Unallowable Travel Expenses

DSAA prohibits the use of FMF funds to pay any travel costs for foreign officials in connection with a commercial purchase. In addition, DSAA requires that contractors certify that they will comply with this prohibition. However, the DCAA found evidence that contractors made such payments with FMF funds.

- In a \$189 million Egyptian contract with Westinghouse for radars, auditors found that the contractor had paid \$15,730 in travel costs for Egyptian officials. Westinghouse claimed that the travel costs were paid from company profits, not from FMF funds.
- In the Israeli contract with Commodore Aviation, auditors found that the contractor lacked internal controls to ensure that no Israeli government

<sup>3</sup>UNITRA also represents other U.S. defense firms, such as General Electric, Ford Aerospace, ITT, and Sanders.

officials were reimbursed for travel expenses. The contractor did not have adequate data to determine who was reimbursed for travel, lodging, and other support expenses.

- In a \$31 million Egyptian contract with Alliant Techsystems to upgrade torpedoes, DSAA granted an exemption of up to \$70,000 to allow Egyptian officials' travel costs for a training program. Auditors found that Alliant paid about \$14,000 in travel costs for Egyptian officials to make an inspection visit, which was not covered by the DSAA exemption.

#### Items of Non-U.S. Content

DSAA prohibits the use of FMF funds for items of non-U.S. origin, except with DSAA approval. DSAA also requires that contractors certify that they will comply with this prohibition. The DCAA uncovered evidence that contractors made unapproved payments for non-U.S. goods and services. For instance, in Egypt's contract with Alliant Techsystems, the contractor certified that all goods and services produced or performed under the contract were of U.S. origin. However, auditors found that Alliant had a subcontract worth \$528,000 for administrative and logistics support with Navytron, an Egyptian firm managed by a retired Egyptian Navy Admiral.

#### Factors Contributing to Weaknesses in the FMF Program

A number of factors contribute to the weaknesses identified in the FMF program. Some of these factors are unique to the commercial channel. In particular, when foreign countries use this channel, they lack access to contractor records, increasing the risk that unallowable expenses will be charged to the contract. Moreover, contractors often maintain poor records, making it difficult for DOD auditors to confirm any wrongdoing by the contractor. In addition, the countries' procurement authority may not monitor contractor performance nor exercise the option of using DOD to provide this service. Other factors apply to the FMS channel as well as the commercial channel. Specifically, problems concerning subcontractors, sole-sourcing, and offset agreements may occur regardless of which procurement channel the foreign country uses.

#### Foreign Buyers Lack Access to Contractor Records

The U.S. government has access to a contractor's records for all commercial or FMS contracts. The foreign buyer, in contrast, lacks access to contractor records. Contractors generally restrict the foreign buyer's access to its records in order to protect proprietary data. While the contractor's restriction on access to its records is valid, and we do not intend to suggest otherwise, it also means that the foreign procurement authority cannot independently assess the contractor's compliance with

DSAA requirements, or validate costs and allowable charges. Only a post-audit by a U.S. government audit agency is likely to detect abuses by the contractor.

On an FMS procurement, the U.S. government is protected against overstated contract prices by the Truth in Negotiations Act, which requires that for noncompetitive contracts over a certain amount prime contractors and subcontractors disclose accurate, complete, and current cost or pricing data. In addition, the Federal Acquisition Regulation (and the DOD supplement) provides guidelines for negotiating the amount of profit a contractor may earn on contracts with the U.S. government.<sup>4</sup> For example, on fixed-price manufacturing contracts, negotiated profits are typically between 6 and 8 percent. The Truth in Negotiations Act and the profit guidelines in the Federal Acquisition Regulation do not apply to commercial contracting.

#### Poor Record-Keeping by Contractors

Even if the foreign procurement authority had access to contractor records for FMF-financed commercial contracts, these records are so poorly maintained that many of the abuses would be difficult to substantiate. In 10 of 11 audits of Egyptian and Israeli commercial contracts, the DCAA found that contractors did not have adequate records or procedures to ensure compliance with the certification to DSAA. The following DCAA audit examples illustrate this problem.

- In the Egyptian contract with Loral Aerospace International, Loral had certified to DSAA that it would maintain accounting records to identify all relevant costs for each separate contract. However, Loral used the same charge number in billing for its contract with Egypt as for a \$32 million contract with Taiwan. The consequent commingling of these records prevented auditors from tracing the actual costs to the specific Egyptian contract.
- In a \$32 million Egyptian contract with Precision Machining for trucks, the contractor did not accumulate contract costs by contract line items. Thus, auditors were unable to determine whether commission payments to a sales agent were funded by the contract.
- In a \$16.1 million Israeli contract with ESL, Inc., a subsidiary of TRW, for the integration of an airborne system, auditors found that the commingling of funds between ESL and TRW made it difficult to determine how costs were allocated.

<sup>4</sup>The actual profit earned by the contractor may exceed the negotiated amount.

**Foreign Countries Are Not Required to Contract With DOD to Monitor Contractor Performance**

For FMS contracts, the DCMC monitors the performance of the prime contractor to, among other things, verify that milestones are achieved and goods and services are delivered in accordance with the contract. For commercial contracts, foreign countries may contract with DCMC for these services, and both Israel and Egypt have used DCMC on occasion.

However, this is not a DSAA requirement, and neither Israel nor Egypt has routinely used DCMC to monitor contractor performance. For example, the Israeli MOD depends on the Israeli Defense Forces to monitor contractor performance—a weakness in internal controls that Dotan and General Electric were able to exploit by submitting fraudulent documents to MOD certifying that goods and services were delivered when they were not.

If the FMS channel had been used for the Israeli purchases, Dotan would have had to overcome the prospect of DCMC monitoring contractor performance. Such DCMC intervention might reduce the vulnerability of commercial contracts to some types of fraudulent schemes that occurred in the Dotan affair.

**Neither FMS Nor Commercial Contracting Procedures Exercise Control Over Subcontracts**

As discussed above, the use of the FMS channel rather than the commercial channel may have prevented some types of schemes undertaken by Dotan; however, oversight of subcontractors is weak under both procurement channels. On a commercial contract, the foreign procurement authority relies on the prime contractor to monitor subcontractor performance and on the country's foreign military services to ensure that goods and services are received. Similarly, on an FMS contract, the U.S. government generally relies on the prime contractor to monitor the performance of subcontractors and on the receiving country to certify their performance.

The Dotan affair nevertheless revealed additional weaknesses regarding oversight of subcontractors on commercial contracts. DSAA requires foreign countries to disclose the subcontractors used on a commercial contract and the materials and services they will provide. However, the foreign country is not required to report which of these subcontractors, if any, it has directed the prime contractor to use. Furthermore, DSAA does not require that DCMC perform a pre-award survey to determine whether the subcontractor is capable of performing the work.

The absence of such subcontractor reporting requirements may have contributed to Dotan's ability to defraud the Israeli and U.S. governments. Dotan directed General Electric to subcontract with Ingbir Engineering, an

Israeli firm. According to the Justice Department's complaint, General Electric hired Ingbir through a U.S. subcontractor, GSK Management Consultant, Inc. Ingbir performed services that were not authorized by the Israeli MOD or DSAA, and GSK transferred \$11 million to European bank accounts controlled by Dotan and a General Electric official. To ensure that MOD did not become aware of Ingbir's involvement, Dotan and the General Electric official agreed not to report this arrangement as part of Israel's offset arrangement with General Electric.

**Sole-Source Contracting  
Used Extensively in Both  
FMS and Commercial  
Contracts**

With few exceptions, U.S. government agencies are required to use competitive procurement procedures, while foreign buyers are encouraged, but not required, to seek multiple sources. If the foreign military official ordering the item can justify a sole-source purchase to the country's procurement authority, the U.S. government will generally approve it, whether a commercial or FMS purchase is involved.

On a commercial purchase, DSAA guidelines highly recommend that, "whenever possible, several U.S. manufacturers be contacted." Justification for sole sourcing should be provided with the commercial contract; however, DSAA guidelines provide no criteria for that justification. As such, Israel and Egypt have developed their own criteria which, for the most part, parallel the criteria in DOD's Security Assistance Management Manual. The monthly listings Israel submitted to DSAA from 1990 to early 1992 indicate that 95 of the 130 commercial contracts or purchase orders between \$500,000 and \$1 million were awarded sole source. Of these 95 contracts or purchase orders, 53 were reported to be the sole vendor or manufacturer of the item. The remainder were designated sole source based on Israel's history of dealing with the vendor (28) or for security or other reasons (14). No monthly reports have been sent to DSAA since February 1992, and those previously submitted were rarely questioned.

For an FMS purchase, the customer must submit a written justification for sole sourcing to the DOD implementing agency. DOD and FMS procurements are governed by the Federal Acquisition Regulation, but an exception in the regulation gives the foreign buyer greater latitude in source selection. Section 6.302.4 of the regulation provides authority to contract without full and open competition by applying the "international agreement" exception. Instead of complying with the Federal Acquisition Regulation, customer-generated sole-source requests must comply with section 80102 of the Security Assistance Management Manual.

The manual states that sole sourcing may be justified if (1) one of the suppliers can deliver faster and the situation is urgent, (2) the item is nonstandard, (3) the country has a history of procurement from the source and to change would have an adverse impact on the program, (4) the designated source has won the foreign buyer's own selection competition, or (5) the country has an established history of procurement from a particular source which it needs to continue for standardization or logistical reasons.

From October 1991 through July 1992, the U.S. Air Force received 82 sole-source requests from various countries, including Israel and Egypt. Some were later withdrawn by the buyer, but the majority were approved. DOD officials acknowledge that they rarely disapprove a country's request for sole sourcing in an FMS buy, in part, because they have no way of verifying the justification submitted.

#### Offsets Vulnerable to Abuse

Offset arrangements are vulnerable to abuse, especially in commercial sales with unrestricted profits, because contractors can potentially pass on the costs of these concessions by charging the customer a higher price.<sup>5</sup> Even in an FMS case, overcharges would be detected only through an audit. Given that the foreign buyer perceives an economic benefit to the offset, the higher cost may not be an issue for the buyer, particularly if it is paid for by the United States. Moreover, the U.S. government provides minimal oversight of offset arrangements between a foreign government and a U.S. contractor, even though such arrangements are an integral part of the sale.

Offsets are no longer eligible for U.S. financing. However, until 1992 direct offsets were eligible for U.S. financing on a case-by-case basis. As such, Israel requested or, in some cases, required that U.S. contractors use Israeli subcontractors for up to 45 percent of the contract value. According to Israel's records, its offset arrangements with General Electric, for example, totaled about \$30 million on contracts valued at \$150 million. Since fiscal year 1984, Israel has received \$1.2 billion in offset funding.<sup>6</sup> Currently, Israeli commercial contracts contain a standard provision that encourages the contractor to invest at least 35 percent of the contract value in Israeli-based industries.

<sup>5</sup>Offsets are a range of industrial and commercial compensation practices required by foreign governments and firms as conditions for the purchase of military exports. Thus, foreign governments use offsets to obtain technology, support domestic employment, and expand their defense industries.

<sup>6</sup>In addition to offsets, Congress earmarked nearly \$3.3 billion in funds for offshore procurements in Israel for fiscal years 1984-92.

## Conclusions

The Dotan schemes and subsequent audits and investigations revealed that FMF-financed commercial contracting is vulnerable to abuse because of DOD's weak controls over the program and its reliance on recipient countries' procurement safeguards. Even though the U.S. government has a number of advantages over the foreign buyer to prevent fraudulent activities, the FMS procurement channel is not immune from abuses similar to those found in the commercial channel.

In general, there is insufficient U.S. government oversight in both FMS and commercial purchases to ensure that purchased goods and services are provided and that sole-source buying is adequately justified. Additional vulnerabilities exist in commercial contracting because the U.S. government relies on the foreign buyer to oversee the contract, and the foreign buyer generally does not have access to the contractor's records. As a result, contractors' noncompliance with DSAA restrictions, such as those relating to commissions, travel expenses, and foreign content, may go undetected.

DSAA's termination of the commercial sales channel will certainly eliminate some of the vulnerability of the program. However, some of the advantages to the foreign buyer, such as lower prices and quicker delivery of some items purchased through this channel, will be lost.

## Recommendations

We recommend that the Secretary of Defense require that DSAA implement the following controls to improve the FMF procurement system. The first recommendation applies to both FMS and commercial procurements. The remaining recommendations address weaknesses in the commercial channel and would be applicable as long as commercial procurements continue to be funded by the United States.

- To improve oversight of subcontractors, DSAA should require FMF recipient countries and contractors to report all subcontractors required or directed by the country. Also, DSAA should arrange for DCMC to perform a pre-award survey of subcontractor capability, if unknown.
- To ensure greater use of the FMS procurement channel, DSAA should direct U.S. military buying organizations to perform price comparisons on high-value commercial contracts and where the buyer requests a sole-source procurement. Where price and availability are comparable to FMS, DSAA should require that the country buy through the FMS channel.
- To verify that milestones are achieved and services are performed in-country, DSAA should direct DCMC to conduct quality assurance checks

on purchases over a certain dollar threshold. Also, DSAA should require that the foreign country pay the costs for these DCMC services.

- To verify contractor compliance with the certification, DSAA should require contractors, and their subcontractors, to maintain their books and records in a manner that permits the U.S. government to verify contractor compliance.

# Israel Adding Controls Over FMF Procurements

The Israeli government has a number of computerized and manual procedures in place to protect the integrity of its FMF procurements. Our analysis of Israeli purchasing indicated, however, that only one-third of commercial purchases were awarded based on competitive bids from two or more sources. Furthermore, according to the Israeli State Comptroller, procedures governing receiving, inventory, and payment verification were not being followed.

Israeli officials acknowledged these problems and told us they are implementing improvements in their procurement procedures and are considering other improvements. For example, they told us they have reemphasized their preference for FMS purchasing and are trying to increase the level of competitive bidding in contract awards. According to MOD, the Israeli State Comptroller is also verifying that prescribed corrective actions are being implemented.

In addition, the Israelis continue to add controls as a result of their analyses of events in the Dotan affair.<sup>1</sup> In particular, the Israelis told us that the Dotan affair demonstrated the need for them to open up their procurement system to encourage greater review of decisions and to require more involvement of the MOD in decisions previously made solely by the Israeli Defense Forces (IDF). IDF, however, continues to maintain significant leverage in military procurement decisions.

## Israeli Procurement Process Has a Number of Procedural Requirements

The Israeli procurement process has a variety of procedures governing the development of requirements, the preparation of requisitions, the solicitation of offers, the awarding of contracts, the validation of payment, the receipt of goods, and the management of inventory. Many of these procedures are similar to U.S. procedures as enumerated in the Federal Acquisition Regulation. Other procedures are unique to Israel.

A number of Israeli organizations are involved in managing FMF purchases. IDF initiates all requisitions and is the end user of most items. Each of IDF's three military services has its own procurement/logistics function which interacts with MOD. For example, in the Israeli Air Force, the Engineering and Logistics Branch centrally controls all procurement, provisioning, and distribution of items. MOD's Directorate of Procurement and Production manages FMF purchases in Israel. MOD's purchasing mission in New York executes all FMF purchases in the United States.

<sup>1</sup>Israel established an independent commission and committees within MOD to examine the Dotan affair and recommend improvements in the procurement process.

## Operational Requirements

Major system acquisitions begin with the identification of operational requirements within the service branches. These requirements are evaluated based on a current threat assessment, an analysis of the current equipment inventory, and funding expectations. Once approved by the Minister of Defense, new acquisitions and follow-on support are included in Israel's 5-year defense plan. This plan is used to validate requisitions.

## Preparation and Validation of Requisitions

The military services prepare requisitions and allocate funds in their budgets for purchases. Major items and spare parts are managed by item managers in each of the services. The item managers monitor consumption and initiate purchases. Some items are reordered automatically when computerized stock records indicate that stock levels have fallen below established minimum stock levels. The services review their data base on past procurements and use a commercially available computer software program to check U.S. military procurement history. Some requisitions designate required suppliers indicating that for logistical, maintenance, or safety reasons, only one vendor is authorized as the procurement source.

The services send their requisitions by computer to MOD, which checks for budget availability and validates the requisitions against the defense plan. MOD also prepares sourcing sheets indicating the past procurement histories of the required items—vendors used, quantities purchased, and prices paid. It then determines what funds will be used for the purchases: shekels, foreign currencies, or FMF. MOD also approves the services' designations of sole-source suppliers.

## Solicitation of Offers and Award of Contract

After MOD validates the requisition, it is forwarded to the purchasing mission if the purchase is to be made in the United States. The mission determines whether the purchase will be made through the FMS or commercial channel. The mission then solicits vendors, assesses bids received on competitive awards, awards purchase orders and contracts, receives items at its freight forwarder, arranges transportation of these items to Israel, and pays vendors. Items shipped to Israel are turned over to the services' logistic squadrons, logged into inventory, and distributed to installations as needed.

A number of control points are used throughout the process. For example, the mission maintains a pre-approved list of required suppliers, cost analysts evaluate price proposals, teams and committees are assembled to

evaluate and negotiate contracts, and there is a hierarchy of approval on all purchases.

#### Controls Increase After Dotan Affair

According to Israeli officials, Dotan was able to bypass the normal procurement process and budget, requisition, and receive (or falsely claim to have received) aircraft engine parts and logistical support by raising technical and security concerns. Israeli officials told us there is now a renewed emphasis in the Israeli military to "do things by the book." They cited the following as examples of their efforts to increase controls over the procurement process: (1) persons involved in the procurement process are encouraged to raise questions about operational requirements, (2) MOD has become more involved in procurement decisions, and (3) IDF's access to computerized data has been expanded. One way MOD is increasing its involvement is by expanding its participation in program management groups, which are the decision-making teams for major activities, such as Israel's naval modernization project.

Another change involves the role of the resident project officer. On major projects, Israel often maintains a resident project officer at the contractor's facility. These officers are IDF personnel assigned to MOD for their technical expertise. Before the Dotan affair, these officers were not held accountable for failing to follow MOD directives. Israeli government officials told us that new directives have been issued making IDF officers, including resident project officers, legally responsible for following MOD procurement procedures. The mission has also published procedures for monitoring and reporting progress on projects.

According to Israeli officials, a number of other changes to the purchasing process are being implemented or under consideration. The Dotan scandal is a fairly recent occurrence, and significant changes will take time to implement.

While the proposed changes will add additional oversight to the procurement process, IDF will continue to have significant leverage in the buying process. Given the degree of influence IDF has in Israeli procurements, we believe that contractors and IDF will continue to promote a mutually beneficial relationship. As such, the potential for collusion can only be reduced, but not eliminated, a fact the Israelis recognize.

## Limited Use of Competition

Our review of a sample of Israeli commercial purchases indicated that the majority of the purchases were awarded without competition. In general, the use of competition is advantageous because it reduces the risk of contract awards based on favoritism or collusion, and it helps ensure that prices paid are reasonable. According to DOD, adequate price competition is assumed to exist if (1) offers are solicited, (2) at least two offerors capable of satisfactorily performing the requirements independently contend for the contract by submitting responsive offers, and (3) the contract is awarded to the responsible offeror submitting the lowest price.

Table 4.1 presents the results of our review of all commercial purchase orders issued by the purchasing mission in New York between October 1, 1991, and June 30, 1992, which were greater than \$500,000, and a statistical sample of 186 purchase orders valued at less than \$500,000.

**Table 4.1: Extent of Competition in Israeli Commercial Purchases**  
(October 1, 1991, to June 30, 1992)

Value of purchase	Number of purchases	Number competed	Percentage competed
Over \$1 million	30	3	10
\$500,000 to \$1 million	27	6	22
Less than \$500,000	186	67	36

For the 48 purchases of \$500,000 or more that were not competed, 75 percent were either extensions of a previous purchase or involved upgrades to existing systems. The files did not contain information as to whether the original contract or purchase was competed. In our review of purchases under \$500,000, we found an additional 55 purchase orders for which more than one vendor was solicited but only one bid was obtained. In many of these cases, solicited vendors reported that they were unable to bid because they did not recognize the part numbers listed in the solicitation. Our analysis also indicated that the Israelis limited their ability to achieve a higher level of competition because their solicitations did not include sufficient information on the items required, such as technical specifications, drawings, or DOD national stock numbers.

We could not determine if the level of competition identified through our sample showed an improvement from previous periods because the Israelis do not track the level of competition in their purchases. Israeli officials told us of a recent change in mission procedures which requires buyers receiving only one proposal for a particular procurement to either refer the matter in writing to the mission's Deputy Director for Procurement for referral back to the requestor to obtain a better

description of the item required, or to process the buy as a sole-source purchase. They also told us that they were instituting procedures to track the level of competition in their purchases.

**Vendor-Stocked Warehouses**

Our sample included several sole-source purchases which Israel bought commercially from bonded warehouses maintained by four U.S. vendors in Israel. The two warehouses we visited were small, trailer-like structures. Israel requires these vendors to maintain the warehouses to (1) reduce the lead time required to obtain critical parts from the United States, (2) lessen Israel's provisioning needs, and (3) minimize the possibility of "dead inventory" (excess parts purchased to support equipment which is no longer needed). Inventory in bonded warehouses is owned by the vendors, with Israel paying for items when IDF requisitions them.

We found that the commercial prices for items stocked in these bonded warehouses were sometimes higher and sometimes lower than the FMS prices for these items. We asked the Israelis about four particular items (two items from each of the two warehouses we visited) which we identified as being available from FMS stock for \$630 to \$3,670 per unit less than the commercial price through the special warehouse. The Israelis told us the four items were safety items, and the United States bought three of these items from vendors not approved by the Israeli Air Force. For the fourth item, however, the FMS stock was purchased from the same vendor the Israelis used. The FMS price was \$484; the bonded warehouse price was \$2,282. The Israelis recognize that they sometimes pay more than the FMS price for bonded warehouse items, but price is only one consideration. They believe the immediate availability of these items is critical. Purchasing these items through FMS could require 60 days to process and considerable time for delivery and shipping. They added that special committees periodically review and evaluate the contents of the warehouses.

**Competition Can Be Increased Without Compromising Quality**

The Israelis told us that they agreed that their concerns for quality assurance on safety items need not result in the elimination of competition for these items. Mission representatives told us that since the Dotan affair they have been trying to increase the level of competition in their purchases by reducing the number of safety items (discussed in ch. 2) and by identifying alternate vendors for items currently obtained sole-source. If there is a large discrepancy between the price of the alternate source and the price of the current sole-source supplier, the matter will be

referred back to MOD in Israel for further consideration and consultation with IDF.

The need to increase competition has also become Israeli law. In March 1992, the Israeli Knesset passed legislation generally requiring competition for all government contracts. The law was later amended to delay the implementation date until July 1, 1993. Israeli officials informed us that the law will not require any change in their procurement procedures.

If product quality remains a significant deterrence to competition, the Israelis can request quality assurance reviews of U.S. vendors through the DCMC (see ch. 3). The Israelis used DCMC's quality assurance services more extensively in the past, but have reduced their requests for such services in recent years, relying more on IDF inspectors and U.S. consulting firms for the same purpose. However, MOD officials met recently with representatives of DCMC to discuss quality assurance and other services available to them.

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## Receiving, Inventory, and Payment Procedures Are Not Always Followed

Israeli procedures for merchandise receiving, inventory management, and payment authorization, if properly followed, should have prevented or detected Dotan's actions. Many of these procedures, however, were ignored or circumvented, which allowed payments to be made for merchandise that was never received. The Israeli State Comptroller reviewed these procedures after the Dotan affair and found that many problems still existed. MOD representatives told us they have improved and expanded their controls in these areas. The State Comptroller, however, has not yet reported on the effectiveness of MOD's initiatives.

Consistent with the allegations in the civil action complaint filed against General Electric in the Dotan case, it appears that Dotan's schemes worked, in part, because neither MOD, DSAA, nor the Israeli Air Force had implemented adequate procedures to ensure that authorized items were delivered before MOD paid for them. Both MOD and DSAA relied on contractor invoices and certifications of milestone achievement, approved by the Israeli Air Force, for MOD to make payments to the contractor and receive reimbursement from the U.S. government.

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## Shipping Controls

Mission officials told us that the majority of goods ordered in the United States are received at the freight forwarder's warehouse in New Jersey for

shipment to Israel. Clerks at the warehouse compare the packing slips on the crates to copies of the purchase orders, resolving any discrepancies between the packing slips and the purchase orders before the merchandise is shipped to Israel. The clerks, however, are not authorized to open the crates because (1) they may not have the expertise to know if the goods in the crate are the goods ordered and (2) they may damage the packaging and thus assume responsibility for any damage to the goods that occurs in shipment. Mission officials told us that due to the time lag between receiving the merchandise at the freight forwarder and inspecting the goods in Israel, the mission approves vendor payments based on the packing slips.

#### Receiving

The Israelis told us that after the goods are shipped, each military service has a central receiving point where it can verify the receipt of merchandise. However, the State Comptroller reported that contrary to its rules and regulations, some Air Force equipment went directly from the suppliers to the users without verification of receipt by the central receiving unit. The Israelis told us that the Air Force procedures were revised in 1992, so that the authority to certify the receipt of goods lies solely with the central receiving unit, regardless of whether the goods are physically received at the central receiving unit or at other entities within the Israeli Air Force.

Receiving units are to count the merchandise, check it for quality, enter it into their computerized inventory system, and prepare acceptance reports. These acceptance reports are to be sent to MOD's data processing by computer or manually within 30 days to be matched against payments made to vendors. The State Comptroller reported that many acceptance reports were not entered into the computerized system and thus not matched with payments made. As of November 1991, the purchasing unit had open orders totaling 114 million shekels (about \$44 million) for which acceptance reports had not been entered into the computerized system, even though more than a month had passed from the payment date. The Israelis told us that they subsequently had expanded their computerized system to allow more receiving units to enter their acceptance reports on-line.

#### Inventory Checks

One method for detecting items that have been purchased but not received is a periodic matching of inventory records with physical counts of inventory stocks. We visited two spare parts warehouses operated by two

different military services. Warehouse officials told us their personnel do not conduct complete counts of items, but do perform sampling counts throughout the year to compare amounts to the computerized inventory records.

We asked the Israelis to provide us with documentation of the inventory checks performed at the military warehouses over the last 2 years. We received information from the Air Force and the Navy. The Army sent us their inventory procedures but not the results of their counts. Israeli inventory sampling guidelines consider discrepancy rates up to 5 percent as representing acceptable reliability. Discrepancy rates above 5 percent call for expanded sampling counts, according to these guidelines.

The Navy has an automated warehouse, opened in 1991, and several manual warehouses. According to the Navy, a random sampling of the automated warehouse in 1992 indicated a 2.3-percent discrepancy rate (the difference between computerized inventory records and counts), with a loss of \$27,000. The Navy's manual warehouses showed an average discrepancy rate of 7.5 percent, with a loss of \$6,500.

The Air Force began an inventory verification process in 1989, starting with the count of specific item groups. The initial results led to the conclusion that a "wall-to-wall" physical inventory of the 400 Air Force warehouses was necessary. According to the Chief of the Directorate of Engineering and Logistics, the inventory discrepancy rate at that time was probably about 40 percent. The Air Force started the complete inventory in 1990 and expects to complete it in September 1993. The Israelis told us that sampling counts at about 100 Air Force warehouses in 1992 showed an average discrepancy rate of 7.3 percent. The Israelis did not provide us with a loss figure for the discrepancies.

Personnel at the two warehouses we visited told us they were subject to audit by the base commander, the service branch, the MOD Inspector General, and the State Comptroller. However, no audits of inventory accuracy were performed by units outside of the service branches (MOD or State Comptroller) in the last 2 years.

# Egyptian Procurement Safeguards Are Significant but Still Have Some Limitations

Egypt has a number of significant procedures to manage FMF procurements. Written policy guidance details organizational responsibilities and procedures. Separate organizations, primarily the military departments and the Armament Authority, work together to develop requirements, write technical specifications, solicit and evaluate offers, award contracts, and track shipments. Egypt also has a number of procedural safeguards. For example, all offers must be evaluated based on predetermined technical factors. In many ways, Egyptian procurement policies resemble U.S. policies as enumerated in the Federal Acquisition Regulation. Our test check of several contracts indicated that these procedures were working. For example, our review of selected contract files and documents corroborated that competition had occurred in contracts where Egypt had reported competitive procurements to DSAA. We also physically verified that Egyptian warehouses had actually received several FMF items that the Egyptian government had procured.

However, the Egyptian supply system has had problems tracking receipts and reporting discrepancies of FMF items. Egyptian officials were able to show us selected items, picked by us, that had recently arrived in country. Nevertheless, Egypt's automated tracking system recently lost visibility of \$100 million worth of FMF purchases and Egypt required U.S. assistance to track and locate the items. While Egypt's manual inventory management system appeared to be working, and officials never lost physical control over these assets, this problem, as well as other shortcomings documented by the SAO in Cairo, demonstrate that problems continue to exist. In response to our findings, Egyptian officials stated that their inventory management system is generally working well and that planned improvements would correct any current shortcomings.

In addition, although these procedures define the official process within the Egyptian government, they do not control the behavior of contractors outside official channels. As discussed in chapter 3, audits by the DCAA have revealed several questionable practices by contractors.

## Egypt Has Significant Procedures in Place for Commercial Contracts

Egypt's procedures to manage FMF procurements are written into key regulations such as Armament Authority Instruction No. 8/92, regarding the method of foreign acquisition for the armed forces, and Armament Authority Instruction No. 19/91, regarding sole-source contracting. These regulations detail organizational responsibilities and procedural safeguards.

## Organizational Responsibilities

The key organizations in FMF purchases are the military departments, the Armament Authority, and the Washington-based Egyptian Procurement Office within the Ministry of Defense. The military departments have a predominant role in procuring FMF items. The departments develop operational requirements, write technical specifications for goods and services (in conjunction with the Armament Authority), perform technical evaluations on all offers, assist the Armament Authority with contract negotiations, and receive and store FMF material. The military departments also make recommendations (and provide justification) for sole-source and commercial contracts.

The Armament Authority has the key role in writing solicitations, arranging offsets, negotiating and awarding contracts, and generally overseeing the military departments. The Egyptian Procurement Office is responsible for assisting the Armament Authority with solicitation and, in some cases, contract negotiation and award. Officials in these two offices rotate positions every 2 years to prevent any individual from accumulating too much power or establishing too close a relationship with specific contractors.

## Operational Requirements

According to Egyptian policy, the military departments develop operational requirements. The requirements are then reviewed by the Operational Authority<sup>1</sup> and the Armament Authority and finally approved by the Armed Forces Supreme Council. Sometimes the SAO also participates by providing cost data to Egypt. According to Egyptian officials, contractors have no role in determining operational requirements, but their presentations and literature are among the sources of data which are used. The operational requirements form the basis for all goods and services purchased through the FMF program. Egypt has a 5-year modernization plan documenting which goods and services (including their estimated costs) will be needed by the military departments.

## Technical Specifications

The military departments, in accordance with Egyptian policy, are to create a committee to develop technical specifications for goods and services which support operational requirements. This committee is to include personnel from the appropriate military department and, for new requirements, personnel from the Armament Authority. The technical specifications must be clear, accurate, up-to-date, flexible, and written in English. Specifications also must be generic and not limited to products of

<sup>1</sup>The Operational Authority is the Egyptian equivalent to the U.S. Joint Chiefs of Staff.

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specific companies. After, the specifications are approved by the requesting department, the Armament Authority reviews them to ensure compliance with policy guidelines.

In some contracts, the evaluation criteria include proportional weights. For example, the Egyptian Air Force may list performance, tolerance, lead time and warranty as factors in its technical specifications for spare parts, and each factor may have a different numerical weight. The technical specifications committee sets the relative weights for each factor in the technical evaluation, and these weights are sealed until after all offers are received. Under Egyptian policy, these technical criteria and weights are not to be revised, and contractors are to have no access to the information.

During our visit to Egypt, we reviewed technical specifications in 12 contract files. All but one had technical specifications as appropriate. For eight contracts, specifications (with varying degrees of detail) were in the files. For three other contracts, part lists served as the specifications. In only one contract were there no specifications in the file. Egyptian officials could not explain why the technical specifications were not in this file.

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#### **Solicitation of Offers**

According to Egyptian policy, the Armament Authority writes the solicitation based upon the military department's technical specifications. The solicitation includes estimated costs, time frames, and delivery terms. If applicable, the department justifies any request for commercial and/or sole-source contracts. The solicitation is reviewed within the military department and the Armament Authority. The Armament Authority may add requests or requirements for offsets. Then the Armament Authority sends the solicitation to the Egyptian Procurement Office for distribution to potential firms in the United States. The Egyptian Procurement Office receives all offers and forwards them to the Armament Authority, which certifies them as legitimate (that is, received on time) and passes them back to the military departments for technical evaluation. These procedures for solicitation are similar to U.S. procurement rules.

Our review of contract files in Egypt showed that the selection of firms to solicit is based on a variety of sources. The military department sometimes provides a list of companies to solicit. The Armament Authority or the Egyptian Procurement Office may select additional firms from defense and business periodicals, previous procurements, unsolicited contractor

literature, or a computer data base on part manufacturers. We found that no consistent method was used for selecting firms to solicit. The Egyptian Procurement Office is now working to develop standard procedures to solicit offers from firms.

### Technical Evaluation

The military departments, in accordance with Egyptian policy, are to create a technical evaluation committee to review each offer received. This committee includes department officers and engineers experienced in using and maintaining the required item (or similar item), as well as Armament Authority staff. The committee establishes a table or matrix to compare and contrast specific technical factors among the various offers. It disqualifies inadequate offers, tries to equalize different offers, and makes recommendations as to which offers are technically acceptable. The committee's report is reviewed within the department making the acquisition and then forwarded to the Armament Authority for review and approval.

The technical specifications are the main criteria for the evaluation committee's analysis. When applicable, proportional weights are used for evaluating all offers received. While the technical criteria and proportional weights are not to be revised under Egyptian policy, we found one contract, a \$115 million contract for navy mine hunting ships, where the technical specifications were changed during the negotiation process. In its initial report, the committee found that two of the six offers were technically acceptable. Then the committee requested both companies to modify their offers to incorporate additional technical conditions. One company amended its offer to include another power plant, gearbox, and electronic control system; the other company amended its offer to include another type of radar and an improved technical display. While these changes in specifications may seem unusual, U.S. procurement regulations also allow changes in technical specifications during competition.<sup>2</sup>

Overall, the Egyptian procedures for evaluating offers are similar to U.S. procedures under the Federal Acquisition Regulation with respect to including technical factors in the solicitation and conducting technical evaluations. According to an Egyptian official, numerical weights, which may be employed in the evaluation of offers, need not be disclosed in solicitations. This is also true in DOD procurements. Our review of 12 commercial contract files in Egypt indicated that technical evaluations had

<sup>2</sup>According to part 15.606(a) of the Federal Acquisition Regulation, after the U.S. government receives proposals and establishes a competitive range, it can modify requirements and only has to notify "competitive" companies.

been performed for 8 contracts, and 4 contracts required none because they were for additional quantities of spare parts already in the Egyptian inventory.

**Contract Negotiation and Award**

The Armament Authority, in accordance with Egyptian policy, is to establish a committee to conduct contract negotiations with the offerors and recommend specific terms and a specific contractor. This committee includes representatives from the Armament Authority, the Financial Authority,<sup>3</sup> and the appropriate military departments. The committee also has representatives from the Department of Military Justice and the Department of Military Intelligence for contracts over \$500,000. According to Egyptian officials, contractors and their representatives are not allowed to attend committee meetings.

The committee reviews offers for completeness and negotiates with potential firms to obtain the lowest price. The committee considers a number of factors, including conformance with the model contract, results of the technical evaluation, payment terms, and price. The final prices of competing offers are divided by the score in the technical evaluations to get a cost-effective price for comparison. The committee presents its results in a report to the Director of the Armament Authority which contains (1) a summary of the technical evaluation, (2) a chronology of negotiations, (3) a comparison of final offers, and (4) its recommendation. The committee's recommendation must be reviewed and approved by various branch chiefs and the Director of the Armament Authority. After the contract is approved, the Director passes it on to DSAA for FMF funding approval. Egyptian procedures concerning contract negotiation and award are similar to U.S. procedures.

We examined 12 contract files in Egypt and found that the contract committees had documented their activities in accordance with Egyptian regulations. All of the contracts contained documentation from the contract committee and had been approved by appropriate officials; however, one contract committee lacked the requisite representative from the Department of Military Justice.

**Competition Versus Sole Source**

Egyptian policy generally requires open competition in the awarding of contracts. Toward this end, the Armament Authority uses open bids with

<sup>3</sup>The Financial Authority, within the Ministry of Defense, is the Egyptian equivalent to the DOD Comptroller.

negotiated procurements. DSAA guidelines "highly recommend," but do not require, that competition be used and request that countries submit a letter of justification on how the contract was awarded.

Under Egyptian regulations, exceptions to competition (that is, sole-source contracts) can be justified by similar criteria enumerated in U.S. regulations. For example, under Egyptian regulations sole-source contracts may be justified to (1) meet urgent delivery requirements, (2) procure nonstandard items, (3) follow up with an established contractor, (4) ensure commonality among parts, and (5) purchase from a contractor that had been awarded a previous contract on a competitive basis. Any justification for sole-source contracts must be approved by higher levels in both the military departments and the Armament Authority.

DSAA guidelines on commercial contracts also require that sole-source contracts be justified, but the guidelines do not provide criteria. In some contracts, the U.S. government directs the foreign buyer to use sole sourcing. For example, U.S. Navy officials told Egyptian officials that they should request sole-source designation for a particular company for a submarine tactics trainer related to the Harpoon missile program.

Of the 12 contracts we reviewed, 8 were awarded competitively and 4 were awarded sole source. All of the sole-source contracts appeared appropriate under Egyptian regulations (three were based on previous competition and one was nonstandard). While only one-third of the 12 contracts were sole source, they were large contracts, representing \$118.4 million (91 percent) of the \$130.8 million total in our sample of commercial contracts. In all 12 contracts, either competitive or sole source, Egypt's justification to DSAA was accurate. For instance, if Egypt had told DSAA that a sole-source contract was justified by previous competition, our file review was able to confirm that fact.

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**Shipment Receipt and Billing**

Material shipments and receipts are tracked by various systems (both manual and automated) which are maintained by the military departments and the Armament Authority. For goods being delivered, Egyptian officials told us that the Armament Authority sends shipping documents to the appropriate military department after the shipment is sent by the freight forwarder or supplier. When the material arrives in Egypt, the port authority notifies the appropriate military department, which transports the material to its warehouse. The material is examined by a technical

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committee, which consists of representatives from the military department's supply and repair units. This committee examines the goods for damage and potential discrepancies in quantity and quality. If there are no problems, the material is stored and the department's inventory records are updated. If there is a problem, then the committee is required to file a report of discrepancy with the Armament Authority.

Whether there is a discrepancy or not, the warehouse is required to notify the Armament Authority so it can update its contract records. Once the Armament Authority receives confirmation of delivery, it sends documentation to the Egyptian Procurement Office, which requests that DSAA pay the contractor.<sup>4</sup>

Services purchased with FMF are monitored by the appropriate military departments and recorded in a daily log book. For training services, the Training Authority (within the Ministry of Defense) also participates to ensure that appropriate training is being provided. The departmental unit receiving the service issues a certificate to verify that work is being performed. This certificate is approved within the department, then reviewed by the Armament Authority, and finally sent to the Egyptian Procurement Office which processes the appropriate documentation to pay the contractor.

During our visit to Egypt, we physically verified the receipt and storage of several items from recent commercial and FMS contracts. After we selected the items, we gave Egyptian officials 2 days to determine the location of the items and to obtain appropriate warehouse clearances for our visit. In total, we verified the arrival and storage of 94 individual items from 3 contracts. The items were located at four different warehouses, each managed by a different department. We did not find any discrepancies.

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## **Egypt Attempting to Correct Weaknesses in Inventory Management**

While we were able to find selected items in Egypt, our review of documents at the SAO revealed some problems with Egyptian inventory management. These weaknesses affect items purchased under both commercial and FMS contracts. Egyptian officials have twice lost track of sizeable FMS shipments and asked for U.S. assistance in locating the items. In addition, SAO has identified other problems with Egyptian inventory management, problems that Egypt is now seeking to correct.

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<sup>4</sup>Technically, the payment is made not by DSAA, but by the Security Assistance Accounting Center—an agency in the Defense Financial and Accounting Service.

In 1990, the Armament Authority reported to the SAO that Egypt had not received items associated with about 1,500 requisitions which were reported as shipped by the U.S. military. About 90 percent of the missing items were shipped more than a year earlier. This indicates that the Egyptian military was slow in processing discrepancy reports. The U.S. military reviewed records at supply depots and the freight forwarder and concluded that all of the items had been properly shipped. Egyptian officials said they were eventually able to locate most of the items.

In 1991, the Armament Authority reported to the SAO that \$100 million worth of FMS items shipped from the United States was unaccounted for and requested U.S. assistance in clearing up the discrepancy. In its investigation, the SAO took a sample of "missing" items and were able to verify that all of the items had been received and were stocked in Egyptian warehouses. SAO also conducted a complete inventory of Egyptian warehouses for "missing" items in one FMS contract (457 items worth \$542,507) and was able to locate or account for 98 percent of the items.

In both incidents, the problem was caused by Egypt's transferring data from its manual system to its automated system for inventory management. Egypt's military departments, except the Air Force, have a manual tracking system at their warehouses.<sup>5</sup> This system works, as demonstrated by our own observations and SAO's ability to track the "missing" items reported by the Armament Authority. However, the Armament Authority has a parallel automated tracking system which, in this case, did not work. One of the problems with the automated system involved single shipments of multiple FMS items, sometimes numbering in the thousands. Because of the large volume of items, Egyptian receiving personnel entered only the first item on the multiple packing list into the automated system. Thus, all remaining items were never recorded as being received. Even though the Egyptian military's manual system worked and Egypt never lost physical control over these assets, the Armament Authority was not aware that the assets had been received and stored.

The SAO's report to the Armament Authority on the 1991 incident pointed out a more serious problem: shipping discrepancies that are identified may not be reported and researched. The office gave the following reasons:

- Egypt has a severe shortage of technical support officers in procurement and supply operations. It is common practice to have a single officer

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<sup>5</sup>The Egyptian Air Force does have an automated inventory management system in place. This system was demonstrated to us on our visit to Egypt.

submitting requests, tracking requisitions, managing inventory, issuing items, and reporting discrepancies. Thus, many of these activities are done poorly or not at all.<sup>6</sup>

- Items are not centrally managed. The lack of central management and, thus, coordination among departments has hindered requisition tracking, shipment tracking, and submission of discrepancy reports.
- The supply system has little automation. Currently, many departments use "black books," rather than computers, to track receipts. This lack of automation leads to difficulties in communication among organizations to follow up on shipments and discrepancies.<sup>7</sup>

Egyptian officials, in response to our findings, said that the SAO's report exaggerated the problem. The officials showed us that many discrepancy reports were being filed. However, they acknowledged some problems with their inventory management system and said they were taking corrective actions to resolve current shortcomings. For example, the Armament Authority and the SAO are planning a standard central material management organization, with automated controls to match supply documents with the physical movements and storage of material. To implement such improvements, Egypt recently signed an LOA to spend \$1.5 million for automating selected warehouses. In addition, Egyptian officials told us that they planned to spend \$2.4 million in national funds to support automation by building special warehouses and purchasing special equipment.

<sup>6</sup>In addition to creating enormous work loads for such officers, this situation represents an internal control weakness because there is no separation of duties.

<sup>7</sup>Automation is not totally lacking in the current system. However, the few inventory and stock control systems that are automated operate only in limited areas. These independent systems are decentralized and do not communicate or consolidate data with other automated systems.



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